SUMMARY AND REQUEST FOR ORAL ARGUMENT

For tax years 1993, 1994 and 1995, appellants filed joint federal income tax returns and deducted losses arising from two Subchapter S corporations. The appellants had sufficient basis in indebtedness of the S corporations to allow them to take into account these losses under I.R.C. § 1366(d). In addition, appellants were personally liable on the indebtedness to the S corporations for purposes of the "at-risk" rules under I.R.C. § 465. Appellants' conclusions are supported by the language of the Code, the case law and the economic substance of the lending transactions at issue.

The Tax Court, however, found that appellants did not have sufficient basis in the two S corporations. The Tax Court erroneously held that appellants' lending transactions had no economic substance and appellants were not at risk.

Appellants respectfully submit that the Tax Court made numerous factual errors in reaching its decision and erred as a matter of law in its application of the statutes in question.

Appellants request oral argument of 20 minutes per side.

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JURISDICTIONAL STATEMENT

The Commissioner issued a notice of deficiency to the Donald G. and Beverly J. Oren (collectively referred to as the "Orens" and individually referred to as "Don Oren" and "Beverly Oren") dated December 6, 1999, relating to 1993, 1994 and 1995.[1] Add. 17a. The Orens timely petitioned the Tax Court under section 6213(2) of the Internal Revenue Code.[2]App. 2. A trial was held on June 7, 2001, before the Honorable Robert P. Ruwe. App. 2. The Tax Court issued a memorandum opinion unofficially reported at Donald G. and Beverly J. Oren v. Commissioner, 2002 T.C.M. (RIA) ¶ 2002-172. Add. 1a. The Tax Court entered its final decision against the Orens on July 24, 2002. App. 1, 2. The Tax Court had jurisdiction of this case under sections 7442 and 6214.

The Orens timely filed a Motion to Vacate or Revise Decision on August 23, 2002, pursuant to Tax Court Rule 162. App. 2. On November 5, 2002, the Tax Court denied the Orens' Motion to Vacate or Revise Decision. The Orens timely filed their appeal on January 31, 2003, within the 90-day appeal period

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[1] As a result of the Commissioner's proposed disallowance of the Orens' adjusted basis, the Commissioner determined tax deficiencies of $1,375,232 for 1993, $2,138,632 for 1994, and $1,777,271 for 1995. Add. 1a; App. 1. The Commissioner accepted a $200,000 increase in the Orens' adjusted basis which related to personal assets loaned by Don Oren. Add. 29a n.20.

[2] All references to the Internal Revenue Code and the Treasury Regulations shall be to the 1986 Code, as amended, and the Treasury Regulations promulgated thereunder, hereafter I.R.C. or Code.

provided under section 7483 and Fed.R.App.P. 13(a)(2). App. 3. This Court has jurisdiction over this appeal pursuant to section 7482.

STATEMENT OF ISSUES

1. Did the Tax Court err as a matter of law in its application of section 1366(d) to determine whether appellants' had increased their adjusted basis in their S corporations?

The most pertinent authorities are:

I.R.C. § 1366;

Gitlitz v. Commissioner, 531 U.S. 206 (2001);

Bergman v. United States, 174 F.3d 928 (8th Cir. 1999), rev'g and remanding, No. 3-96-850 (D. Minn. Dec. 19, 1997) (unpublished opinion, Add. 40a);

Gilday v. Commissioner, 43 T.C.M. (CCH) 1295 (1982).

2. Did the Tax Court err as a matter of law by applying the incorrect legal standard under section 465 to determine whether appellants were at risk for amounts borrowed that were contributed to the business activities of their S corporations?

The most pertinent authorities are:

I.R.C. § 465;

Moser v. Commissioner, 914 F.2d 1040 (8th Cir. 1990);

American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990).

3. Did the Tax Court make numerous factual errors in its review of the record below such that its decision must be reversed?

The most pertinent authorities are:

Wal-Mart Stores v. Commissioner, 153 F.3d 650, 657 (8th Cir. 1998);

Black Hills Corp. v Commissioner, 73 F.3d 799, 804 (8th Cir. 1996).

STATEMENT OF THE CASE

The Orens are husband and wife, and filed joint federal income tax returns for 1993, 1994 and 1995. Add. 2a, 16a. The Orens have operated successful businesses in the trucking industry primarily through S corporations. Add. 2a-4a, 25a; App. 284-85. During the years at issue, the Orens and their three sons were active managers and owners of the various businesses. Add. 3a-4a; App. 48 (¶ 111), 269-72. Two such businesses, Highway Leasing Company ("HL") and Highway Sales, Inc. ("HS"), were wholly-owned by Don Oren and began expanding in 1992 and 1993. As a result of increased equipment purchases, HL and HS began generating tax losses in 1993, 1994 and 1995 from accelerated depreciation deductions. Add. 5a-6a.

Don Oren transferred a total of $15,500,000 in cash to HL and HS during the years in question in exchange for four notes. Add. 8a-12a. Accordingly, the Orens adjusted basis in HL and HS was collectively increased by $15,500,000. Consistent with their increased adjusted basis, the Orens deducted the tax losses from HL and HS on their federal tax returns. Add. 16a.

The Orens submitted that their loss deductions were proper under section 1366(d)(1) because they had an adjusted basis in HL and HS equal to the indebtedness of HL and HS to Don Oren as shareholder. (Relevant portions of section 1366 at Add. 39a.)

Don Oren borrowed most of the funds that he contributed to HL and HS from a related entity, Dart Transit Company (“Dart”). Add. 8a-12a. Under section 465 Don Oren was “at risk” on his borrowing from Dart because he was personally liable. (Relevant portions of section 465 at Add. 38a.)

The Tax Court, however, ignored the plain language of the statutes in question and improperly interpreted facts not in dispute. The Tax Court erroneously held that the Orens’ lending transactions were economically without substance and that Don Oren was not at risk on his Dart loans.

The Orens appeal based upon factual errors arising from the Tax Court’s findings that improperly interpreted facts not in dispute, and legal errors arising from the Tax Court’s improper legal standard for review of loss deductions under section 1366 and the “at-risk” rules under section 465.

The Tax Court’s decision should be reversed.

STATEMENT OF FACTS

The Orens' business strategy, corporate structure and capital investments must be placed in their proper perspective, and thus the Orens begin with a discussion of the evolution of their businesses and a description of their capital investments in 1993, 1994 and 1995.

The Orens' businesses were, and still are, actively engaged in three distinct segments of the trucking industry: (1) Truckload Carrier Services, (2) Tractor Sales and Leasing, and (3) Trailer Leasing.[3] Add. 2a-3a, 5a-6a.

The Orens structured their businesses to harness the competitiveness of owner-operator drivers (independent contractors), to restrict tort liability to each separate business, to enhance profitability and financial accountability of each separate business, to structure trailer leasing terms on the most competitive basis possible, to maintain operational flexibility and to facilitate family and estate planning. Add. 6a; App. 291-92. In 1992 and 1993, HL expanded its trailer leasing business by purchasing additional trailers, and HS expanding its tractor leasing business by purchasing additional tractors. Add. 7a, 11a**.** These growth opportunities gave rise to depreciation deductions generating the precise tax losses at issue for HL and HS. Add. 7a, 11a.

[3] The Orens also engaged in other related businesses but they are not relevant to the issues before this Court. See App. 166-211.

Dart, HL and HS each had different customers, creditors, owners and business risks. Add. 6a; App. 287-92. Although all three businesses prospered in the three years at issue, there was no certainty that they would do so. App. 280-84. Like any entrepreneurs, the Orens invested capital in their businesses with no assurance that they would be successful and no assurance that they would avoid any one of a number of possible business catastrophes.

Truckload Carrier Services

Dart was begun in 1934, incorporated in 1938 and remains to this day an important player in the very competitive ‘high service just-in-time’ segment of the truckload carrier industry. Dart offered premium truckload (full load) carrier services to retailers and manufacturers. Dart served a national market by using high-cube (large) van equipment, on medium to longhaul routes. Add. 3a-4a. Dart competed in the largest truckload carrier market (i.e., the longhaul truckload segment) against such carriers as Schneider National, J.B. Hunt Transportation and Landstar System. These carriers were each four to five times the size of Dart in terms of gross revenues.[4] App. 280-85.

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[4] For purposes of describing all of the Orens’ Truckload Carrier Services, Fleetline, Inc. is included here, but it is not otherwise relevant to the issues before this Court. Fleetline was incorporated in 1982 as a Texas-based carrier to serve the large Texas intrastate transport market. Fleetline’s operations were very similar to Dart. Add. 5a.

Unlike some carriers, Dart did not use truck terminals because shippers generally paid for the entire trailer. Dart contracted with the shippers to have trailers moved directly from shipper origin to shipper destination. Dart contracted with independent contractors, who owned or leased their own tractors, to haul the trailers. Add. 3a; App. 287-89.

Dart's management and ownership structure during the years at issue clearly illustrate that Dart was controlled by the Oren family not just Don Oren. In 1993 Don Oren owned 74.94 percent of the Class B (nonvoting stock), and in 1994 and 1995 he owned 54.95 percent. Don Oren owned all Class A (voting stock). Beverly Oren was a director with over twenty years of experience with Dart in charge of human resources. She owned 6.33 percent in all three years. Add. 3a-4a.

Don and Beverly Oren's three sons were actively managing the businesses. Dan Oren was a Managing Director. Dave Oren was Vice-President of Information Systems. Brad Oren was Fleet Service Coordinator. App. 48 (¶ 111), 269-72. Dave, Brad, Dan and Angela Oren (the Orens' minor daughter) each owned 4.69 percent in 1993 and 9.68 percent in 1994 and 1995 (including some amounts held in trust).[5] Add. 4a.

[5] Dave, Brad and Dan Oren were employed by Advantage Management Corp. which provided management services for Dart and related entities. App. 48 (¶ 111), 178, 193, 208, 269-72.

<u>Tractor Sales and Leasing</u>

HS was incorporated in 1971 to provide financing for independent contractors to purchase or lease tractors. Dart contracted only with independent contractors. Reliable contractors were always difficult to locate. The business goal for HS was to promote opportunities for reliable contractors to lease or own their own tractors thereby increasing the pool of reliable contractors. Add. 5a-6a; App. 288-89.

<u>Trailer Leasing</u>

HL was incorporated in 1987 as a service company that owned trailers and leased them to Dart, Fleetline and third parties. Add. 5a; App. 290-92.

<u>Direct Shareholder Loans</u>

Don Oren loans to HL and HS. Don Oren made four direct shareholder loans during 1993, 1994 and 1995 to HL and HS totaling $15,500,000. Add. 7a-12a. Don Oren transferred $15,500,000 in cash (by check) to HL and HS in exchange for four notes. <u>Id</u>.; App. 213, 216, 219, 222.

The four notes were written instruments executed contemporaneously with the transfer of funds, contained a specific interest charge and provided a procedure for repayment upon demand. Add. 8a-12a. HL and HS intended to repay the notes when they were issued and both companies had the financial means to repay the notes when they were issued. App. 109-111, 166-211. HL and HS each paid the interest each year on the notes by checks written on their respective corporate accounts and paid the notes in full in 1996. Add. 8a-12a, 14a-16a. The notes were unconditional and legally enforceable.

HL and HS purchased trailers and tractors, respectively, for use in their leasing businesses. HL and HS leased the equipment to their customers, but did not enter into any sales-leaseback arrangements with Don Oren or Dart. App. 74. The notes to Don Oren were not intended to and did offset lease payments by the customers of HL and HS. Repayment of the loan principal was subject to the loan terms and was subject to risk of nonpayment by HL and HS. Add. 7a-12a; App. 213, 216, 219, 222.

Related Lending Transactions

Dart Loans to Don Oren. The funds used by Don Oren for his loans to HL and HS were obtained both from personal funds ($200,000)[6] and from personal loans ($15,300,000) from a related entity, Dart. Add. 7a-12a, 29a n.20. The four notes from Dart were written instruments executed contemporaneously with the transfer of funds, contained a specific interest charge and provided a procedure for repayment upon demand. Dart transferred the funds each year to Don Oren by a check written on its corporate account. Add. 8a-12a; App. 212, 215, 218, 221.

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[6] Don Oren owned sufficient personal assets that would have allowed him to contribute cash to HL and HS in 1993, 1994 and 1995. Add. 8a n.3.

Don Oren's repayment was not contingent on any event nor was his repayment connected to Don Oren's receipt of shareholder income from HL or HS. Don Oren paid the interest each year on the notes by checks written on his personal account and paid the notes in full in 1996. Add. 14a-16a. The Dart loans to Don Oren were unconditional and legally enforceable.

Dart generated operating profits and maintained a line of credit for managing cash needs on a daily basis. Add. 7a. Dart used its operating profits and its line of credit funds in its Truckload Carrier Services. Dart did not enter into any sales-leaseback arrangements with Don Oren, HL or HS. App. 74. Don Oren's notes to Dart were not intended to and did offset operating income from Dart's business.

Don Oren intended to repay his four loans from Dart when each loan was executed and he had the financial ability to repay each loan at the time that each loan was executed. App. 93, 109, 111, 139-65. Don Oren's business practice was to repay all loans. App. 110.

HL and HS Loans to Dart. After Don Oren borrowed the funds from Dart, he transferred the funds to HL and HS in exchange for notes**.** After receipt of Don Oren's loan proceeds, HL and HS transferred the funds to Dart in exchange for notes. Add. 7a-12a; App. 214, 217, 220, 223. The transfer of funds from HL and HS to Dart was made each year by checks written on their respective corporate accounts. 8a-12a.

The three notes from HL and one note from HS were written instruments executed contemporaneously with the transfer of funds, contained a specific interest charge and provided a procedure for repayment upon demand. Dart paid the interest each year on the notes by a check written on its corporate account and Dart paid the notes in full in 1996. Add. 8a-12a, 14a-16a. The notes to Dart were not intended to and did offset lease payments by the customers of HL and HS. The notes were unconditional and legally enforceable.

The funds transferred to Dart pursuant to the loans from HL and HS did not repay any previous loans from Dart to HL and HS. Rather the new loans in 1993, 1994 and 1995 from HL and HS were accounted for and reported separately from any pre-existing debt from Dart. App. 180, 195, 210.

Banking Agreement

Prior to and during 1993, 1994 and 1995, Dart operated under a banking agreement that provided a revolving line of credit. Add. 7a. The parties to the banking agreement included Dart, HL, HS and Don Oren. Id. None of the parties to the banking agreement were in violation of any covenants and the bank was aware of all the loans at issue in this case. App. 111.

Generally, Dart was constantly borrowing funds pursuant to the line of credit. Dart maintained a zero balance account in which the bank would 'sweep' the bank account daily for cash received from operations to credit Dart under its line of credit. App. 111-13, 118-20, 139-65. Pursuant to the banking agreement all parties were obligated to honor their various debts. See Add. 7a.

Audited Financial Statements

Dart, HL, HS and other related entities owned by the Orens had their combined financial statements audited during the years in question. App. 168, 184, 199. The audited combined financial statements present the financial position (referred to as the "Combined Balance Sheet"), results of operations and cash flows of companies under common ownership and management as if they were one company (referred to as the "One Company"). Id. The audited combined financial statements also include additional combining information (referred to as the "Additional Combining Information"). App. 166-211.

The Additional Combining Information included in the audited combined financial statements on the One Company presents the loan obligations between Dart and Don Oren, Don Oren and HL/HS, and HL/HS and Dart on the balance sheet information of the individual companies (Dart, HL and HS) because the individual companies had a legal right to receive or a legal obligation to pay the amount of the loan obligations. App. 180, 195, 210. Recording the right to receive and the obligation to pay the loan obligations resulted in a gross up of assets and liabilities of the individual companies. Id. This presentation reflects the legal and economic substance of the loans. The One Company, however, offset the loan obligations between Dart and Don Oren, Don Oren and HL/HS, and HL/HS and Dart to arrive at the Combined Balance Sheet in accordance with accounting principles generally accepted due to the underlying loan agreements. App. 169, 185, 200; App. 258-65; cf. Add. 12a-14a nn.5-7.

Trucking Industry Expert

Mr. Terry, trucking industry expert, opined that the Orens' organizational structure facilitated the Orens' success in the competitive trucking industry because such structure:

> Harnessed the competitive power of independent contractors (drivers) for HS;
>
> Recognized the need and business opportunity for providing financing for independent contractors by HS;
>
> Recognized the inherent tort liability risk containment opportunities that exist in the multi-corporate structure;
>
> Used a multiple carrier and service entity approach to improve the linkage between management and profitability and the visibility of the profit-making activities; and
>
> Used simplified rental rates (per diem and per mile) for the lease of its trailers. App. 290-92.[7]

[7] The Tax Court ignored the expert's report and the Commissioner did not challenge any conclusions or findings of the expert report.

<u>SUMMARY OF ARGUMENT</u>

This case concerns two statutory requirements that were satisfied by the Orens and thus allows them to deduct tax losses from two S corporations on their joint federal income tax returns:

(1) S corporation indebtedness to shareholders that qualifies for <u>tax basis</u> under section 1366(d)(1); and (2) taxpayer borrowing for contribution in business activities in which the taxpayer is <u>at risk</u> under section 465.

The Tax Court erroneously concluded that the Orens' basis in the indebtedness of HL and HS for purposes of section 1366(d) was limited to the amount of such indebtedness that was funded from Don Oren's personal assets. In other words, the Tax Court found that the Orens' basis in the indebtedness of HL and HS to them did not include the amount of such indebtedness that was funded by Don Oren's loans from Dart. As explained below, the Tax Court's decision is inconsistent with a plain reading of the Code, case law, such as this Court's decision in <u>Bergman</u>, <u>supra</u>, and the economic substance of the lending transactions.

The Orens satisfied the form and substance required by section 1366(d)(1) to increase their adjusted basis in HL and HS when Don Oren transferred a total of $15,500,000 in cash to HL and HS and received in exchange four notes from HL and HS. The Orens also established at trial that Don Oren's loans to HL and HS were genuine. The Orens are entitled to judgment on these facts alone under section 1366(d)(1). Although not required by section 1366, the Orens also established at trial that the related lending transactions were also genuine and did not invalidate their investments in HL and HS. The court below erred by its failure to accept these facts as conclusive under section 1366.

The Orens also satisfied the test for at-risk investments under section 465. The Orens proved at trial that Don Oren was personally liable for the recourse notes from Dart. The Orens are entitled to judgment because the lending transactions did not eliminate Don Oren's personal liability for the Dart notes and thus did not constitute a loss-limiting arrangement within the meaning of section 465(b)(4). The court below erred by finding that the Orens' lending transactions were similar to certain sale-leaseback transactions and thus constituted an arrangement to limit the losses of the Orens.

The Orens appeal, based on the factual errors arising from the Tax Court ignoring facts not in dispute, the legal errors arising from the Tax Court reaching a result not supported by the evidence and erroneously applying the incorrect legal standards under sections 1366 and 465.

The Tax Court's decision should be reversed.

ARGUMENT

I. THE TAX COURT ERRED AS A MATTER OF LAW AND FACT BY DENYING THE ORENS' BASIS IN THE INDEBTEDNESS OF HL AND HS UNDER SECTION 1366.

A qualifying business may elect to have its profits and losses allocated pro rata to its shareholders rather than pay corporate income tax. If the election is made, the shareholders report such profits and losses on their individual income tax returns. I.R.C. § 1366(a). The reporting of losses from S corporations is limited, however, to the extent the shareholder has a basis in the S corporation. I.R.C. § 1366(d).

Congress enacted this provision on reporting losses from S corporations to enable the shareholder to deduct only the amount that he has invested in, or loaned to, the S corporation. See S. Rep. No. 85-1983 (1958), reprinted in 1958 U.S.C.C.A.N. 4791, 5008. Shareholders may acquire basis in an S corporation by contributing capital or directly loaning money. I.R.C. § 1366(d).

A. The Tax Court's Decision Is Inconsistent with the Plain Language of the Code.

The plain language of section 1366(d)(1) provides that S corporate indebtedness to its shareholders qualifies as adjusted basis for purposes of shareholders claiming deductions or losses arising from the S corporation. The purpose of the statute is to provide shareholders with a procedure for investing in an S corporation in a manner that increases adjusted basis. This is precisely what the Orens intended to accomplish, thus their lending transactions were legitimate procedures used to satisfy "the thing which the statute intended." Knetsch v. United States, 364 U.S. 361, 365-67 (1960) (interpreting loan transactions) (quoting Gregory v. Helvering, 293 U.S. 465, 469-70 (1935)); Bergman, 174 F.3d at 931 n.6, 932.

The issue of law presented, i.e., the Tax Court's application of section 1366, is subject to a de novo review. Wal-Mart Stores v. Commissioner, 153 F.3d 650, 657 (8th Cir. 1998).[8]

The starting point in analyzing the amount of loss that can flow through to the shareholders of an S corporation is the plain language of the Code. The Supreme Court has acknowledged the importance of respecting the plain language of the Code in Gitlitz, 53113 U.S. at 215-16, a case that also involved section 1366. There, the taxpayers were shareholders in an insolvent S corporation. The taxpayers took the position that they were entitled to increase their basis in their stock by income from the discharge of indebtedness ("DOI") of the S corporation. The increased basis then was used to flow losses through to the taxpayers from the S corporation. Because the S corporation was insolvent, the

[8] Even if the issue is a mixed question of law and fact, it is still subject to de novo review. 153 F.3d at 657; see, e.g., Black Hills Corp. v. Commissioner, 73 F.3d 799, 804 (8th Cir. 1996). Any purely factual findings are subject to a clearly erroneous standard of review. 153 F.3d at 657; see Black Hills Corp., 73 F.3d at 804.

DOI income was excluded from the S corporation's income under section 108.[9] The Government argued that allowing the taxpayers to increase stock basis by use of the DOI income produced an inappropriate windfall to the taxpayers.

The Supreme Court, however, found that the taxpayers were entitled to the basis increase based on a plain reading of section 1366(a). That section provides that a shareholder increases its basis in S corporation stock by "items of income" of the S corporation. The Government argued that excluded DOI income should not be treated as an item of income for purposes of section 1366 because it is "tax deferred" as a result of the section 108 attribute reduction rules, rather than "tax-exempt." The Supreme Court, however, focused on the plain reading of the Code and concluded that excluded DOI income is an item of income that passes through to the shareholders and increases their basis in the S corporation stock. Id. at 212. In reaching its conclusion, the Supreme Court acknowledged the "windfall" concern, but stated: "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." Id. at 220.

"The general rule is that unless there is some ambiguity in the language of a statute, a court's analysis must end with the statute's plain language." Coggin Automotive Corp. v. Commissioner, 292 F.3d 1326, 1332 (11th Cir. 2002) (citing

[9] Section 108(d) was amended subsequent to the Gitlitz case by Congress. See Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 402(a) (2002).

Caminetti v. United States, 242 U.S. 470 (1917)). In Coggin Automotive, the court interpreted section 1363(d) to determine under what conditions a recapture of LIFO benefits will be triggered to an S corporation. The court found that the taxpayer did not own the type of property required by the statutory language to trigger recapture. Id. at 1331-32. There was some concern by the lower court in Coggin Automotive that holding companies electing S corporation status might be able to achieve a windfall if the statute were applied as written. Id. at 1332. Nonetheless, the court of appeals held for the taxpayer in spite of any perceived benefit when "'the Code's plain text permits the taxpayers here to receive these benefits . . .'" Id. (quoting Gitlitz, 531 U.S. at 220) (citing Hillman v. Internal Revenue Service, 250 F.3d 228, 234 (4th Cir. 2001); Brown Group, Inc. v. Commissioner, 77 F.3d 217, 222 (8th Cir. 1996) (the Tax Court's perceived loophole "is not ours to close but must rather be closed or cured by Congress.")).

In this case, as in Gitlitz and Coggin Automotive, the language of the statute is plain and unambiguous. Section 1366(d)(1)(B) provides that a shareholder's basis results from "any indebtedness of the S corporation to the shareholder." Add. 39a.

Here, Don Oren had no basis in the stock of HS and HL. The Orens, however, had basis in indebtedness of the S corporations (HL and HS) to the shareholder (Don Oren) in the amount of $15,300,000. Thus, under section 1366(d)(1)(B), the Orens should be permitted to take into account up to $15,300,000 of losses and deductions from HL and HS.

The Tax Court, however, appears to add a condition to section 1366(d) that is not in the Code, the Treasury regulations or its legislative history. The Tax Court added a “source of funds” limitation by holding, in effect, that the aggregate amount of losses and deductions that can be taken into account by a shareholder cannot exceed the shareholder’s adjusted basis of any indebtedness of the S corporation, *except for any indebtedness that is funded by the shareholder borrowing from a related party.* As the Supreme Court indicated in Gitlitz, however, courts are bound to construe the plain meaning of the Code. Gitlitz, 531 U.S. at 212. If there is a deficiency in the language of the Code, it is the responsibility of the Congress, not the courts, to revise the Code. See Coggin Automotive, supra; Hillman, supra; Brown Group, supra.

As one commentator noted discussing the issuance of the technical advice memorandum in the administrative stages of the Bergman case:[10]

> In effect, the Service is punishing S corporation shareholders for having access to cash from a source other than an unrelated third-party lender. The shareholder is being penalized solely because the original loan (of actual funds) was made by related corporation rather than by an unrelated third-party lender. The Service is implicitly applying an attribution rule in the context of § 1366(d)(1)(B), so that funds that are obtained by a shareholder from

[10] See 174 F.3d at 930.

> a related corporation and then loaned or contributed to an S corporation controlled by that same shareholder will not be treated as indebtedness of the S corporation to the shareholder. Because there is no such attribution rule contained in § 1366(d) or in any other section of the Code, the Service simply has no authority to apply such a rule.

Stephen R. Looney, Recent Developments, J. of S Corp. Tax'n, 129, 135 n.23 (1998).

Even under a close scrutiny of Don Oren's loans from Dart, there is no reason to conclude that Dart would not have enforced Don Oren's obligation to it if HS and HL been unable to pay their obligations to Don Oren. Dart was not wholly-owned by Don Oren; rather Beverly Oren and the Orens' three adult children were active managers and held minority interests in Dart. Dart had rights under state law to enforce Don Oren's obligation to it and Don Oren had other assets that he could have been forced to use under state law to satisfy his obligation to Dart. Finally, Dart's receivable from Don Oren became a valuable asset of Dart; creditors of Dart likely would have been extremely concerned if Dart did not enforce all of its rights with respect to that asset.

Don Oren was unconditionally obligated to pay Dart $15,300,000 pursuant to the four notes. This Court has defined "indebtedness" under the Code as "an unconditional obligation to pay." Gilman v. Commissioner, 53 F.2d 47, 50

(8th Cir. 1931). So long as Don Oren's loans to HL and HS were genuine,[11] the Orens are entitled to deduct the tax losses from HL and HS.

B. The Tax Court's Decision Is Inconsistent with This Court's Decision in Bergman.

Most guaranty/no cash transfer cases fail judicial scrutiny because the shareholder was ultimately found to be either a guarantor of a previous loan or attempting to create a debt with paper only, i.e., no economic outlay (no transfer of cash or value). The Tax Court erred below when it failed to distinguish factually this case from the guaranty/no cash transfer cases. Here the fact pattern shows that no guaranties were present and the shareholder made an actual transfer of cash in exchange for a note, thus creating legal indebtedness of the S corporation to the shareholder.

In a case that with factual similarities to this case, this Court reviewed a loan transaction in which the original cash transfer to the S corporation (AF3) was not from the shareholder (Bergman). Bergman, supra. One of Bergman's wholly-owned S corporations (AF2) made a loan to another Bergman, wholly-owned

[11] The record contains no facts, apart from the mere existence of the lending transactions themselves, that the loans involved were conditional or legally unenforceable. For example, the record proves that there were no guaranties, no nonrecourse loans, no identical offsetting book entries for lease and note payments, no cash transfers and no stop-loss agreements in this case. See Moser, 914 F.2d at 1047-50 (facts included identical offsetting book entries for lease and note payments, no cash transferred, guaranties and nonrecourse loans).

S corporation (AF3). Funds were transferred from AF2 to AF3 at that time. Under section 1366(d)(1), Bergman received no increase in his adjusted basis when the cash transfer was made from AF2 to AF3. Bergman, 174 F. 3d at 929-30.

Bergman 'rearranged' the original loans on December 20, 1990, so that the loan to AF3 was from him, not from AF2. Thus, Bergman made two new loans: the first new loan obligated Bergman to repay AF2 the funds originally transferred from AF2 to AF3; and the second new loan obligated AF3 to repay Bergman for the funds previously transferred from AF2 to AF3. In December 1990, AF3 transferred cash to AF2 in repayment of the original loan from AF2. AF2 then transferred the funds to Bergman who then transferred the funds to AF3. Bergman argued on a summary judgment motion that he satisfied the form and substance of section 1366(d)(1), i.e., transfer of cash to AF3 in exchange for a note from AF3. Id. The District Court agreed holding in Berman's favor that he had made a valid loan to AF3 and was entitled to deduct the losses of AF3. Id. at 931

In an unpublished opinion granting summary judgment for the taxpayer in the case of Bergman (see Add. at 41a), the District Court had cause to provide a thoughtful and focused analysis of the legal issues implicated when direct loans are made to an S corporation by its shareholders.[12] In so doing, the Orens assert, the

[12] Without undermining the District Court's analysis, this Court remanded Bergman on appeal because of unresolved factual issues that made the case unsuitable for disposition by summary judgment. The factual issues included determining

District Court correctly summarized the prevailing law in this area and enunciated the correct guiding principles for a section 1366 analysis, which follow:

(1) When a shareholder transfers funds to an S corporation in exchange for a note, the source of the shareholder funds is irrelevant under section 1366 and the Gilday, supra, decision (discussed below). Add. 44a.

(2) There is no inference of a sham transaction simply because a taxpayer takes advantage of section 1366 and loans funds to an S corporation to create tax benefits. The form of the taxpayer's transaction under section 1366 must be respected. Add. 44a-45a. This clearly includes the direct loans from Don Oren to HL and HS.

(3) There is no sham simply because the taxpayer controls the lending entity. The government must point to some evidence that the loans from the related entity are not in reality loans. In Bergman, the record reflected that the loans were recorded on corporate books, interest was accrued and paid and the loans were repaid. Add. 45a. All such facts, and more, were proven by the Orens regarding all the loans in this case, thus establishing their validity. See Gilman, supra.

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whether Bergman ever intended to enforce his loan to AF3. Id. at 934. Unlike the Bergman case however, this case contains no such unresolved issues of material fact. The record is clear that all the parties treated the loans as genuine from inception to repayment. Consequently, although the Orens acknowledge the limited precedential value of the unpublished Bergman case, the District Court's clear and well-reasoned opinion nevertheless remains highly persuasive on the merits.

Don Oren's control of Dart, however, was overstated by the Commissioner and the Tax Court. Don Oren had voting control of Dart, but his family was actively engaged in running the businesses and retained all their rights as minority shareholders under Minnesota law to force repayment of Don Oren's loans. See Add. 26a-27a n.17; Minn. Stat. Ann. §§ 302A.476 and 302A.751. As a practical matter, Don and Beverly Oren made taxable gifts of Dart stock to their children in excess of $5,500,000 and Don Oren's failure to repay his loans from Dart would have drastically diluted the value of such gifts.[13] Add. 4a-5a.

(4) The economic outlay doctrine applies only to guaranty cases and does not apply to direct shareholder loan cases. Add. 46a-47a. The Tax Court erroneously applied the doctrine to this case. Contrary to the evidence that the transactions between the parties were properly documented and that cash was actually transferred, the Tax Court found that the Orens' lending transactions "were the equivalent of offsetting bookkeeping entries," and that the loans had no "net economic effect." Add. 20a-22a.

Furthermore, the Tax Court incorrectly characterized the loans from HL and HS to Dart as an improper use of the loan proceeds from Don Oren. The court below stated that the S corporations (HL and HS) should have retained the loan

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[13] The Orens paid approximately $2,000,000 in gift taxes for these gifts. Add. 5a.

proceeds for use in their respective businesses. Add. 21a n.12. There is no such requirement under section 1366 for the use of loan proceeds.

The Tax Court also erroneously interpreted the loan repayments in 1996 as evidence that the loans lacked economic significance. Don Oren, Dart, HL and HS all repaid the outstanding loans at issue in this case in 1996 after the Commissioner indicated his intent to deny any increase in basis from the original shareholder loans. Add. 22a-24a n.15.

Contrary to the Tax Court's interpretations, repayment of the loans is evidence that all the parties (1) observed the form and terms of the original loan documents, (2) had a legitimate business purpose to minimize potential tax exposure resulting from the Commissioner's proposed denial of tax basis and (3) treated the loans as genuine. The parties simply exercised their rights to repay in 1996 rather than wait for the full 375 days. The existence of favorable terms in the notes and early repayment are not evidence of a lack of economic reality when viewed in the overall context of adherence to the form and terms of the loans by all the parties. Cf. Bealor v. Commissioner, 72 T.C.M. (CCH) 730, 770-72 (1996); also Helba v. Commissioner, 87 T.C. 983, 1011 (1986), aff'd, 860 F.2d 1075 (3d Cir. 1988); Arrowhead Mountain Getaway, Ltd. v. Commissioner, 69 T.C.M. (CCH) 1805 (1995).

The Tax Court's finding that the 1996 loan repayments are evidence that the transaction lacked economic significance is contrary to the clear statutory language of section 1366 and erroneous as a matter of law. Furthermore, all of the purely factual findings cited by the Tax Court in support of its conclusion that the lending transactions lacked any economic substance are clearly erroneous. See Wells-Lee v. Commissioner, 360 F.2d 665, 672-73 (1966) (finding the Tax Court's finding as clearly erroneous regarding amortization).

Unfortunately for Bergman, however, his deposition testimony revealed that he did not recall whether he intended to enforce his loan in the event of a default by AF3. This Court on review of the summary judgment decision examined Bergman's debt rearrangement to determine whether the December loans were genuine. Finding that there was a genuine issue of fact regarding the validity of the December loans, this Court reversed and remanded. Bergman, 174 F.3d at 934.

In the course of reviewing Bergman's adjusted basis under section 1366(d)(1), this Court found that because the source of the original funds was AF2, not Bergman, Berman's adjusted basis was not increased unless the December loans were genuine. Id. If on remand the December loan was proven to be valid, Bergman's loan to AF3 could increase his adjusted basis in AF3 even though the funds were borrowed from a related entity.

C. The Tax Court's Decision Is Inconsistent with Other Cases Analyzing Shareholder Basis.

1. Direct transfer of shareholder funds satisfies section 1366 even if shareholder funds borrowed from a related party.

Several other cases also illustrate that a shareholder's direct contribution of funds to an S corporation satisfies section 1366, even if the funds were borrowed originally from a related party. See Culnen v. Commissioner, 79 T.C.M. (CCH) 1933 (2000), rev'd and remanded on other grounds, 28 Fed. Appx. 116 (3rd Cir. 2002);[14] Gilday, supra. In the most recent case, Culnen, the shareholder borrowed funds from his wholly-owned corporation and transferred the funds to another wholly-owned S corporation. The court held that the shareholder satisfied section 1366 and was allowed deductions resulting from his increased basis in his S corporation from his loans at issue. Id. at 1937-38.

The District Court in Bergman relied on the Gilday, supra, decision to support its holding. In Gilday, the shareholders originally guaranteed a loan where a bank transferred cash to their S corporation. Later, the shareholders substituted their personal note in exchange for cancellation of the note from the S corporation.

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[14] The Tax Court's legal ruling allowing the taxpayer's deduction of shareholder losses was not changed on appeal, only the amount of loss allowed. The court of appeals held that the amount of loss claimed by the taxpayer was allowed in full because the Commissioner failed to challenge the amount of S corporation loss until the appeal of Tax Court decision, which was unfair to taxpayer. Culnen, 28 Fed. Appx. at 118-19.

After the note substitution, the S corporation reported the original debt as owed to the shareholders and eventually gave the shareholders a note for the original debt. The shareholders argued that the new loan from the shareholders to the bank rearranged the debt from the S corporation to the shareholders. The taxpayers' debt rearrangement argument succeeded. Id. at 1296-97; See also Bhatia v. Commissioner, 72 T.C.M. (CCH) 696 (1996) (description of the Commissioner's position as articulated in Rev. Rul. 75-144, 1975-1 C.B. 277).

2. Shareholder debt creation requires transfer of funds or value.

Some cases which have analyzed shareholder loans purporting to increase adjusted basis have involved fact situations in which no cash (or value of any kind) was transferred to the S corporation.

In Perry v. Commissioner, 54 T.C. 1293, 1295 (1970), aff'd, 27 A.F.T R.2d (RIA) 1464 (8th Cir. 1971), the shareholders advanced some cash to the S corporation and forewent rental payments from the S corporation with no formal loan documents. The Commissioner accepted the cash advances and foregone rental payments as indebtedness from the S corporation, even without proper loan documentation.

In addition, however, the shareholders exchanged notes between themselves and the S corporation. No cash or anything of value was given by the shareholders to the S corporation when they exchanged additional 'notes.' The shareholders argued that the mere exchange of notes, without anything else, increased their adjusted basis in the S corporation. Id. at 1295-97. The shareholders' debt creation argument failed because the Tax Court found that the mere exchange of paper "in the absence of an actual loan of money" cannot create indebtedness for purposes of shareholder basis. Id. at 1297.

3. Shareholder generally cannot recast original form of transaction.

Some cases which have analyzed shareholder loans purporting to increase adjusted basis have involved fact situations in which the cash originally loaned was not directly from the shareholder and the shareholder attempts to recast the original transfer as if it was from him. These cases usually involve situations where the shareholder was originally a guarantor of the debt of the S corporation to a third party. Courts have universally held that a "guaranty is merely a promise to pay in the future if certain unfortunate events should occur. . . [and result] in no economic outlay, and have suffered no cost." Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 n.9 (4th Cir. 1989)

In Estate of Bean v. Commissioner, 268 F.3d 553, 556 (8th Cir. 2001), the shareholders' related partnership transferred assets directly to the S corporation. The shareholders argued that the assets had equity and that the transfer really was from them as shareholders (and partners of the partnership), not the partnership. This Court, however, found that the assets had no equity (thus no cash or value transferred) and that the transfer was from the partnership, not from the shareholders/partners. Thus, the shareholders' argument to recast the debt failed. Id. at 556-58.

In Grojean v. Commissioner, 248 F.3d 572, 572-73 (7th Cir. 2001), the shareholder guaranteed a bank loan to his S corporation (not at issue) and "participated" in another loan from the bank to the S corporation. The shareholder argued that his loan participation was tantamount to a direct loan to the S corporation. The shareholder's argument to recast the loan participation as a direct loan failed because the court found that the participation was both in form and substance identical to a guaranty. Id. at 573-77.

Judge Posner defined the difference between a loan and a guaranty: "the loan supplies funds to the borrower, and the guaranty enables funds to be supplied to the borrower." Id. at 573. In the Orens' case, Don Oren loaned the funds directly to HL and HS without the presence of any guaranty.

In Estate of Leavitt, 875 F.2d at 421, the shareholders originally guaranteed a loan where a bank transferred cash to their S corporation. Although the bank issued the loan in part based on the financial strength of the shareholders, the S corporation made the payments of principal and interest on the loan. The shareholders argued that the loan to the S corporation was really from them. The shareholders' argument to recast the debt failed because the court found that the shareholders were only guarantors of the bank loan, both in form and substance. Id. at 422-24; cf. Selfe v. United States, 778 F.2d 769, 774-75 (11th Cir. 1985) (court found that there was a material fact question requiring reversal of summary judgment decision; case remanded for the district court to determine whether in reality the bank loan was made to the shareholder because the loan officer relied primarily on the shareholder for repayment, not the S corporation).

4. Shareholder can rearrange existing debt under certain conditions.

Some cases which have analyzed shareholder loans purporting to increase adjusted basis have involved fact situations in which the cash originally loaned was not directly from the shareholder and the shareholder attempts to rearrange the existing debt as if the original debt was from him. See Bergman, supra; Gilday, supra.

In Underwood v. Commissioner, 535 F.2d 309, 310 (5th Cir. 1976), the shareholders' C corporation advanced cash to the shareholders' S corporation in exchange for a note.[15] Later, the shareholders gave a note to the C corporation for

[15] This Court addressed the Underwood case in the Bergman decision and cited two cases that support Underwood. Both of these cases, however, involved transfers of cash directly from third parties to an S corporation. At the time of the original cash transfer, the shareholders were guarantors or joint obligors of the

the amount previously loaned to the S corporation and in exchange the C corporation marked the original loan from the S corporation as paid. The S corporation then gave a note to the shareholders for the same amount of the original loan from the C corporation. No cash was transferred at the time that the new notes were exchanged. The shareholders argued that, notwithstanding no cash being transferred, the new loans rearranged the debt from the S corporation to the shareholders.

The court, however, found that the new debt was not genuine because no new cash was transferred and it was not clear that the shareholders would ever receive a demand from the C corporation to repay the loan. Id. at 311-13. Thus, the shareholders' debt rearrangement argument failed. See Reser v. Commissioner, 112 F.3d 1258, 1264 (5th Cir. 1997) (taxpayer basis argument failed; taxpayer offered 'evidence' of loans to S corporation only after the Commissioner's notice of deficiency was received by the taxpayer; all prior evidence confirmed that the taxpayer was a guarantor of loans to S corporation); see also Wilson v.

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original loan by the third party to the S corporation. The shareholders never transferred any cash to the S corporation nor did they ever even attempt to 'rearrange' the notes. The shareholders later argued that the cash was really from them, but the courts rejected their arguments. See Brown v. Commissioner, 706 F.2d 755, 756-57 (6th Cir. 1983); Hafiz v. Commissioner, 75 T.C.M. (CCH) 1982, 1983-84 (1998).

Commissioner, 62 T.C.M. (CCH) 1122 (1991) (loans by related corporation to S corporation were later 'reclassified' on books as loans from shareholder and loans from related corporation were distributed to shareholder); Shebester v. Commissioner, 53 T.C.M. (CCH) 824 (1987) (same); Burnstein v. Commissioner, 47 T.C.M. (CCH) 1100 (1984) (same).

In Hitchins v. Commissioner, 103 T.C. 711, 712-15 (1994), the shareholders of a C Corporation and an S Corporation loaned funds to their C Corporation and received a note in exchange. The C Corporation invoiced the S Corporation for the amount of expenses incurred relating to the development of a chemical database. The S Corporation paid the invoice by combination of cash and assumption of the note owed by the C Corporation to the shareholders. The C Corporation, however, was not relieved of its liability to the shareholders, nor was a note executed between the S Corporation and the shareholders. Id. The court held that no basis was created by the structure of this loan. Id. at 719.

The Tax Court also stated, however:

> We are not unaware of the fact that petitioner might well have succeeded had he adopted another form of the transaction in question, *e.g.*, by way of a novation releasing CCC from liability and obtaining a replacement note from CMB. Alternatively, petitioner could have lent $34,000 to CMB, and then CMB could have paid its debt to CCC, and CCC could have paid its debt to petitioner. The result would have been that CMB would be directly and solely indebted to petitioner in the amount of $34,000. Under *Gilday* and other precedent, the form of such a transaction would have been upheld, and petitioner would have had a basis in CMB's indebtedness.

Id. at 718-719 (emphasis added).

In this case, Don Oren loaned money to HL and HS. Don Oren's loan from Dart does not alter in any legal manner his direct shareholder loans. Furthermore, HL and HS loans to Dart also do not alter in any legal manner Don Oren's direct shareholder loans to HL and HS.

D. The Tax Court's Decision Ignored the Economic Substance of the Lending Transactions.

The Tax Court's decision is based in large part on its conclusions that the economic positions of the parties did not change as a result of the lending transactions and that the lending transactions did not have economic substance. These conclusions, and the ultimate holding, however, reflect the Tax Court's misunderstanding of the facts of the lending transactions. As explained below, each of the loans was bona fide and, taken as a whole, the lending transactions did change the economic positions of the parties and did have economic substance.

1. Each of the loans was bona fide.

All the notes in this case were written instruments executed contemporaneously with the transfer of funds, contained a specific interest charge and provided a procedure for repayment upon demand. Add. 8a-12a.

All the parties transferred the funds by checks written on appropriate corporate (Dart, HL and HS) or individual (Don Oren) accounts. Add. 8a-12a.

All the parties intended to repay the notes when they were issued and all the parties had the financial means to repay the notes when they were issued. App. 109-111, 166-211.

All the parties paid the interest due each year on the notes by checks written on appropriate corporate (Dart, HL and HS) and individual (Don Oren) accounts and all the parties repaid the notes in 1996. Add. 8a-12a, 14a-16a.

Pursuant to the banking agreement, the bank was aware of all the loans between the related parties and no party was in violation of the banking agreement. App. 111; Add. 7a.

Dart, HL, HS and other related entities had their combined financial statements audited by Deloitte & Touche in 1993, 1994 and 1995. The lending transactions at issue here were presented on the Additional Combining Information and subsequently offset for purposes of the Combined Balance Sheet pursuant to generally accepted accounting principles. App. 169, 185, 200; App. 258-65; cf. Add. 12a-14a nn.5-7.

The notes were unconditional and legally enforceable.

2. The lending transactions taken as a whole had economic substance.

As indicated in the facts, Dart loaned money to Don Oren, Don Oren loaned the same amount to HS and HL, and HS and HL loaned the same amount to Dart. The Tax Court viewed this "circular flow of funds" as an indication that the economic positions of the parties did not change. This, however, is not the case. Even though cash followed this route, each of the parties had different rights and obligations after the lending transactions than they had beforehand. This is best illustrated by way of example.

Assume that HS leased a tractor to an individual. The individual is seriously injured in an accident while driving the tractor. The individual sued HS and received a substantial judgment against HS, exceeding HS' current ability to pay. The individual then sought HS assets – including its receivable with respect to the loan from HS to Dart – in satisfaction of the judgment. The net effect of such an event would be as follows: (1) Dart would have an obligation to pay funds to the individual and Dart would have a right to receive funds from Don Oren; (2) Don Oren would have an obligation to pay Dart; and (3) Don Oren would have no hope of receiving any money from HS. This is clearly a different economic result than had Dart just retained the funds all along. This example demonstrates that, by virtue of entering into the various lending transactions, the economic positions of each of the parties changed. After the lending transactions, the parties had different risks, different obligations and different rights.

Admittedly, the likelihood was not great that one accident would reach such a magnitude as to exceed HS' ability to pay. In fact, HL, HS and Dart all fared well economically during the years at issue. Nonetheless, as the past few years have shown, even companies that prosper in one year can suffer economically, if not fail completely, in the next. Thus, the parties had no guaranty at the time the loans were entered into that protected them from bearing the burden of the obligations of the various loans. It was clear, however, that the parties were taking on new risks and were acquiring new rights. This is what lenders and borrowers do. Lenders lend money to borrowers who they expect will repay them. Lenders acquire receivables that are valuable assets in the exchange. Borrowers borrow funds that they expect to repay and are obligated to repay. The lending transactions at issue here possess these very same aspects and have economic substance like any typical lending transaction.

Nonetheless, the Tax Court focused on the fact that there was no evidence that Dart, HL or HS would have been unable to repay their respective loan obligations. As a threshold matter, this is not relevant. There is no statutory requirement that the borrower be unlikely to repay in order for a loan to be valid. See Gefen v. Commissioner, 87 T.C. 1471, 1503 (1986). A prudent lender expects to be repaid when he agrees to make a loan. That is why a lender usually lends to borrowers who are "good" credit risks. The fact that the lender is likely to be repaid does not make the loan any less real. The key is that the lender has acquired certain rights and the borrower has taken on certain obligations. This is precisely what has happened in the instant case. By borrowing from Dart, Don Oren took on a liability. He, therefore, became obligated to pay back the amount borrowed, regardless of whether or not he received repayments with respect to his loans to HL and HS.

The Tax Court erred as a factual matter in concluding that it was “highly improbable” that Dart would have made demand on Don Oren to repay his loans from Dart. This conclusion is wrong as a factual matter. First, Dart’s receivable from Don Oren became a valuable asset of Dart; creditors of Dart likely would have been extremely concerned if Dart did not enforce all of its rights with respect to that asset. Second, Dart was not wholly owned by Don Oren, the minority shareholders had rights to enforce the loans to Don Oren under state law. Third**,** Don Oren’s failure to repay the loan to Dart would have been directly contrary to his family and estate plans already in place prior to the lending transactions at issue here.

The validity of loan must be determined according to State law and the Commissioner never made any challenge to the notes as legally unenforceable under Minnesota law. Federal tax law does not restrict genuine indebtedness to cases where the borrower is “highly unlikely” to repay the loan. <u>See</u> <u>Gefen</u>, 87 T.C. at 1503.

Congress provided section 1366(d)(1) as the procedure for shareholders to increase their adjusted basis in an S corporation. The Commissioner seeks to ignore the clear directions provided by section 1366 contrary to the recent guidance offered by the Supreme Court in interpreting section 1366. See Gitlitz, supra. The Orens ask this Court to reject the Commissioner's argument and to hold that the statute means precisely what its says.

II. THE TAX COURT ERRED AS A MATTER OF LAW BY CONCLUDING THAT DON OREN WAS NOT PERSONALLY LIABLE ON LOANS FROM RELATED PARTY.

Taxpayers may deduct losses to the extent that they are at risk with respect to certain activities, such as equipment leasing. I.R.C. § 465(a) and (c)(1)(C). Add. 38a. Taxpayers are generally considered at risk in an activity to the extent of money they have contributed for use in the activity. I.R.C. § 465(b)(1). With respect to amounts borrowed for use in the activity, taxpayers must show they are personally liable. The Orens established that Don Oren loaned $15,500,000 in cash to HL and HS; Don Oren borrowed $15,300,000 from Dart; and Don Oren was personally liable to Dart for repayment of $15,300,000.

A. The Tax Court Erroneously Concluded that Section 465(b)(4) Is Applicable to the Orens' Lending Transactions.

For purposes of section 465, the Commissioner did not challenge that (1) Don Oren transferred cash to HL and HS in exchange for notes, (2) Don Oren borrowed (most of) the funds from Dart to loan to HL and HS, (3) Dart issued a note to Don Oren for the amount borrowed, and (4) the note from Dart to Don Oren was recourse and valid under Minnesota law. These unchallenged facts establish that the Orens must prevail as a matter of law under section 1366 and section 465.[16]

The Commissioner's only challenge comes under the auspices of section 465(b)(4). The Commissioner argues that the cumulative effect of the related lending transactions between Don Oren and the related parties constituted an exception to the at-risk rules. This exception provides that taxpayers are not at risk if the amounts contributed or borrowed are "protected from loss through nonrecourse financing, guaranties, stop loss agreements, or other similar arrangements." I.R.C. § 465(b)(4).

The Orens established at trial that the loans between Don Oren, Dart, HL and HS were recourse notes, involved no guaranties and contained no stop-loss agreements. The Commissioner's position is based solely on the loan structure. The loan transaction in this case was circular in the sense that the original transfer of cash was from Dart to Don Oren; then Don Oren transferred cash to HL and HS; and finally HL and HS transferred cash to Dart. All transfers of cash were in exchange for recourse notes. The Commissioner concedes that "no rule exists that

[16] The Tax Court's application of section 465 is subject to de novo review, as are any mixed questions of law and fact. See Wal-Mart Stores, 153 F.3d at 657. The Tax Court's purely factual findings are subject to the clearly erroneous standard of review. Id.

holds circular payments to per se constitute 'an other arrangements [sic] for purposes of § 465(b)(4)." See Tech. Adv. Mem. 109286-99 (Sept. 15, 1999).

B. The Tax Court Erroneously Concluded that The Orens' Lending Transactions Are Analogous to Sale-Leaseback Transactions.

The Commissioner argued that the Orens' loan structure was the same as found in many sale-leaseback transactions, and the Tax Court agreed. But the application of sale-leaseback cases to this case is erroneous as a matter of law and is based on the court below improperly interpreting the facts. The Tax Court failed to directly connect the 'arrangement' (i.e., the related lending transactions) with the leasing activity, which is required by section 465(b)(4). As the sale-leaseback cases illustrate, Congress was concerned that leasing activities were the subject of various arrangements that were designed to provide tax benefits of equipment ownership without being at risk on the underlying leasing income generated by the equipment. Consequently, if a sale-leaseback transaction operates to remove the risk from the leasing activity, the taxpayer will be deemed to be not at risk and unable to deduct any related losses from the arrangement. See, e.g., Moser, 914 F.2d 1047-50.

Consistent with congressional intent, courts have traditionally applied section 465(b)(4) to situations in which the borrower was protected by a collateral agreement that limited the losses of the taxpayer, or that reimbursed the taxpayer if payments were not made, such as an insurance policy, a guaranty or an agreement that the borrower would be relieved from having to pay his note. Id. at 1048-50. But in this case, these factors were not present.

Furthermore, the form of sale-leaseback transactions generally involve the last purchaser of equipment leasing the equipment back to one of the prior sellers. In this case, HL and HS purchased the equipment from unrelated third parties. Neither HL nor HS leased the equipment back to the original sellers. Both HL and HS retained ownership and leased the equipment (trailers and tractors) to their customers, who were unrelated to the sellers of the equipment. HL and HS were in the business to generate lease income. HL and HS did not 'arrange' for their lease income to offset their loan payments to Don Oren. The transactions were completely independent of one another. For the sale-leaseback analogy to apply, there must be a direct relationship between the lease payments and note payments (for the borrowing related to the equipment). Some sale-leaseback transactions are designed so that the lease payments and note payments are identical and offset one another as a means to control, and in some cases eliminate, risk between the parties. Id.

The Commissioner relies on the word "circular" to describe the Orens' loans in this case in the hope that he will persuade this Court to overlook the underlying economics and ignore the statutory requirements of section 465. The Commissioner, however, has failed to point to any evidence that the loans between the parties were part of an arrangement to the eliminate Don Oren's risk of nonreceipt of HL and HS leasing income, as required by the cases cited by the Commissioner.

The court in American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990), carefully explained that the various partners in a sale-leaseback transaction had structured their loans so that the loan payments were identical to the lease payments for the leased computer equipment and the notes were all nonrecourse.

> Thus, the payments on [partner A's] long-term note to [partner B], the payments on [partner B's] long-term note to [partner C], and the minimum payments on [partner C's] lease from [partner A] were all identical. No party had sufficient resources to make its payments without receiving the payments due it. The parties, therefore, satisfied the three equal obligations each month by offsetting bookkeeping entries. No cash ever changed hands.

904 F.2d at 480 (emphasis added).

In American Principals Leasing Corp., the general partner and various limited partners (including one limited partner, Baldwin) assumed the debt of partner A in the scenario described above. The court analyzed whether this scenario prevented partner A (or Baldwin, the party assuming partner A's debt) from suffering any economic loss if the computer leasing transaction turned out unprofitable. Id. at 483.

Applying the analysis from American Principals Leasing Corp. to this case, the Commissioner must prove that Don Oren was prevented, by the loans at issue, from suffering any economic loss if the leasing businesses of HL and HS turned out unprofitable. Unlike the scenario in American Principals Leasing Corp., the loans at issue in this case were not contingent upon or equal to the receipt of leasing income by HL and HS. The loans were not in any way connected to the leasing income of HL and HS. Don Oren, as a shareholder/creditor of HL and HS, remained at risk at all times on the receipt of leasing income by HL and HS.

Two other critical factors raised by the court in American Principals Leasing Corp. were (1) the financial inability of the various partners to satisfy their offsetting obligations, and (2) no cash ever changing hands between the partners. Under such a scenario, no partner would ever demand payment and break the chain of the monthly offsetting bookkeeping entries which were identical. Id. Unlike this scenario however, all the parties in this case had the financial ability to satisfy the loans, the annual interest payments and the final payment of the interest and principal in 1996. Furthermore, cash was transferred between the parties at the time of the original transactions. Add. 15a-16a.

The Commissioner cited the Moser case as support, but as this Court stated, “The facts in [American Principals Leasing Corp.] are nearly identical to the case at bar.” Moser, 914 F.2d at 1049. The Commissioner’s argument appears to be that because the flow of funds in this case traveled between related parties with similar terms, then the economic result is identical to the circular loan/lease payments in American Principals Leasing Corp. and Moser. But the application of these cases requires that the Commissioner prove that the loans in this case eliminated any possibility of losses from the leasing activities of HL and HS. Nothing in the record directly links the loan payments to the lease payments received by the leasing customers of HL and HS.

The Commissioner cited below, Levien v. Commissioner, 103 T.C. 120 (1994), aff'd, 77 F.3d 497 (11th Cir. 1996) (per curiam), to support his claim that the Orens were not at risk under section 465. In Levien, three critical facts supported the holding: (1) presence of guaranties of lease payments to taxpayer, (2) presence of nonrecourse debt and (3) identical and offsetting lease and note payments. Id. at 127. None of these three factors is present in this case.

The Commissioner cited below, Vander Heide v. Commissioner, 75 T.C.M. (CCH) 1588 (1998), in support of his position. In Vander Heide, both the debt and lease payments were circular and offsetting, thus eliminating the taxpayer's risk of loss for the leasing activity. "Not only were the debt and rental payments matching in amount and timing, but the flow of payments was circular." Id. at 1592.

The Tax Court in Vander Heide relied extensively on Levien and the same factors present in both cases to find no risk by the taxpayer. These sale-leaseback cases, however, simply do not have any relevance to the Orens' loans for purposes of applying section 465.

The Commissioner's argument is that because this case is controlled by these sale-leaseback cases, this Court must apply the "realistic possibility" test to determine whether the Orens could suffer a loss. Sale-leaseback cases, however, require that the courts analyze whether the loans offset lease payments so that the taxpayer was protected from risk of loss in the underlying leasing activity. Because the loans and lease payments were merely offsetting book entries in many such cases, the courts typically found that the taxpayer had no risk of loss on the receipt of leasing income. See, e.g., Moser, supra.

With respect to HL/HS' leasing businesses, however, the Tax Court failed to appreciate the Orens' business risks. Nothing in the loan transactions eliminated the business risks associated with the leasing businesses of HL and HS. As an investor in HL and HS, Don Oren faced the same prospect of profit or loss as any businessman. The Tax Court erroneously suggested that the Orens' "excellent economic return" in the past and adequate insurance is a guaranty of profits in the future. Add. 25a-26a. No business can guaranty that it will continue to generate profits in the future based on historical returns or sound business operations in the past. Only if the loans in this case removed all risk that HL and HS would become unprofitable should the Commissioner's challenge succeed.

Either HL or HS could have suffered economic losses from a decline in the value of their equipment. Did such a decline in value occur in 1993, 1994 or 1995? No, according to Mr. Terry, expert witness. App. 288-99. Were HL and HS therefore unlikely to ever experience a decline in equipment value that would jeopardize their profitability? Of course not. The current U.S. economic slowdown provides cogent evidence that the Tax Court has overstated the lack of economic risks, and provides a concrete example of the many factors that can negatively affect any business in the trucking industry.

By comparing the stockholders' equity to net property and equipment for HL, HS and the Dart Companies, it becomes obvious that a relatively small decline in equipment values, or other business reverses, could eliminate the stockholders' equity in HL, HS or Dart :

	Stockholders' Equity As A Percent of Net Property & Equipment[17]		**Stockholders' Equity As A Percent of Property & Equipment Original Cost**
Year	**Highway Sales**	**Highway Leasing**	**HL/HS Combined**
1993	14.3%	6.3%	4.9%
1994	16.4%	8.8%	5.7%
1995	24.5%	10.9%	6.9%

[17] For example, the stockholders' equity for HS in 1993 was $4,022,000 and the net Property & Equipment was $28,178,000, thus stockholders' equity as a percent of Property & Equipment was 14.3%. See App. 180.

See App. 180, 195, 210. Losses in equipment values equal to the above percentages of their net book values of either HS or HL would have fully wiped out their stockholders' equity. With their stockholders' equity gone, it is unlikely they could have fully repaid the loans to Don Oren, but Don Oren would have remained liable to Dart. Likewise a fairly small business reverse in Dart equal to the above percentages would have impaired its ability to repay HL and HS, and in turn their ability to repay Don Oren. These figures demonstrate that the profitability of these companies was subject to many realistic business risks. But there is "nothing in section 465 or its legislative history that requires an owner of property to enter into a transaction with a party that is a poor credit risk in order to be 'at risk' within the meaning of section 465." Gefen, 87 T.C. at 1503.

The Tax Court used hindsight to describe the Oren' financial success as virtually guaranteed. Mr. Terry provided a thorough description of the difficulties faced by the Orens in the highly competitive trucking industry. App. 280-84. The Tax Court, unfortunately, completely ignored Mr. Terry's testimony and the Commissioner failed to challenge any specific facts or conclusions reached by Mr. Terry. App. 131-135. The Orens' financial success certainly deserves recognition but not because it was "guaranteed" to happen, but rather because it did happen in such a competitive industry.

CONCLUSION

The Orens have complied with the plain language of section 1366 and accordingly, are entitled to deduct losses from HL and HS on their individual returns for 1993, 1994 and 1995.

The Orens have proven under section 465(b)(2) that Don Oren was personally liable to Dart and the lending transactions were not part of an arrangement to eliminate the business risks of the leasing businesses of HL and HS under section 465(b)(4). Accordingly, the Orens are entitled to deduct losses from HL and HS on their individual returns for 1993, 1994 and 1995.

The Tax Court's decision should be reversed.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 03-1448

Donald G. Oren and Beverly J. Oren,

Appellants,

vs.

Commissioner of Internal Revenue,

Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT
DONALD G. OREN AND BEVERLY J. OREN

CERTIFICATE OF COMPLIANCE

The undersigned, counsel of record for Appellant certifies, pursuant to Fed. R. App. P. 32(a)(7)(B) - (C) and Eighth Circuit Rule 28A(c) - (d), that this brief complies with the following requirements:

(i) The number of words in the brief is 12,365**;**

(ii) The name and version of the word processing software used to prepare the brief was Microsoft Word 97**;**

(iii) The diskette containing the full text of this brief has been scanned for viruses using the Trend Office Scan – Corporate Edition 5.

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